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MEMORANDUM FOR: The Record *S-08339*

The attached was prepared for transmission by ISA to the Secretary of Defense who is reviewing the effect of U.S. involvement in foreign military programs.

Our contribution responded to questions posed by Mr. Glenn B. Blitgen, Special Asst. for Iranian Affairs, Office of the Assistant Secretary of Defense for International Security Affairs.

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[redacted] authored the project which was coordinated with CCI and OSR.

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Chief  
Near East/Africa Branch  
Developing Nations Division *15 July 1975*  
(DATE)

REPLACES FORM 10-101  
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Attachment:  
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- 1 - Draft LDX to Dept. of Defense on 14 July
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Iran: Economic Impact of the Shah's Military Program

I. Defense Expenditures

The Shah's efforts to speed up the modernization and expansion of his military forces, underway since 1967, have caused defense spending to grow much faster than that of any other major sector. Expenditures on defense over the past eight years rose fifteen fold to some \$9 billion in 1975 -- about 1/5th more than is spent on development. Defense spending during 1967-75 totaled about \$26 billion, or 37% of total governmental expenditures. It currently accounts for 41% of the budget. Table 1 depicts the rapid growth in defense expenditures in relation to Gross National Product and the budget.

II. Military Implications

The massive military buildup has provided the Shah with one of the strongest military forces in the Middle East. The Iranian armed forces now number about 454,000 -- double their 1967 strength -- and are equipped with some of the most modern air and ground weaponry in the world.



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Iranian naval forces are rapidly acquiring vessels and aircraft for missions well beyond Iran's immediate shoreline.

Although untested in major military action, Iran's massive force has played a key psychological role in deterring both internal dissent and moves against Iran by unfriendly powers. This strength has enabled the Shah to protect his vital oil lifelines in the Gulf, annex contested islands deemed necessary for Iran's security, and extend his political influence throughout the region.

### III. Economic Implications

Although it is impossible at this point to arrive at a quantitative assessment of economic benefits and costs to Iran from its vast military expenditures, some general conclusions can be made. First of all, it seems apparent that the strong military force developed by Iran has contributed to the internal stability and security that has permitted the regime to carry out its economic developmental programs and encourage participation of foreign investors. During earlier periods of high unemployment, the military helped absorb thousands of Iran's potentially jobless. The armed forces also trained and educated hundreds of thousands of the largely illiterate populace. Moreover, the income and secondary industries generated by military spending were beneficial

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to the Iranian economy during the earlier stages of growth.

It can be argued, however, that alternative use of military funds for social, infrastructural, and direct economic development in earlier periods would have alleviated some of the more pressing economic problems Iran now faces. More investment in irrigation and infrastructure in earlier years, for instance, would have put Iran in a better position to cope with current agricultural and transportation needs. Moreover, the persistent balance of payments difficulties in all but the last few years reflect the costs of massive military imports. In 1970, for instance, Iran's military imports accounted for about 1/4 of current account payments and were equal to over 80% of the current account deficit. Military debt repayment in that year equated to about half of the capital account outflow.

IV. Military Relationship with Current Economic Problems

Most of Iran's current economic problems would exist even if there were no mammoth military program. The military effort, however, adds to the severity of these problems. Thus, for example, the military demands for construction accentuate the shortages and difficulties in building elsewhere in the economy. Similarly, in the case of Iran's skyrocketing inflation, military spending has abetted the

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upward pressure on prices. And, in the case of current port congestion, it appears that military imports add considerably to the problem.

V. Iran's Major Economic Problems

A. Shortage of Skilled Workers -- Regarded by the Shah as the "single most important bottleneck to the economy", the current shortage of some 700,000 skilled and semi-skilled workers is a problem without a short-term solution. Training of indigenous workers, now being vigorously developed, will not fill the gap. As one Iranian official stated, "There is no pill that will cure overnight Iran's need for doctors, managers, engineers, etc." Nor is the wholesale importation of foreign workers a practical solution, given the strongly xenophobic character of the Iranian populace and the probable concern of the government with the activist philosophies introduced by such foreign workers. While recruitment of large numbers of Western and Asian workers will continue, Iran's labor needs will not be met within the next several years. The interim shortage of skilled labor may well force a slowdown or stretch-out of Iran's development program.

B. Port and Transportation Bottlenecks -- (For a detailed analysis, see the appendix.) -- The rapid expansion

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of Iranian imports associated with both military and economic development has led to a serious congestion of Iran's ports and inland distribution system. The rail system is also affected with bottlenecks at important foreign connections such as that with the USSR at Jolfa. Barring a sharp curtailment in purchases -- most unlikely -- we do not look for any real relief in the congestion until port expansion programs and other transport improvements are completed three or more years hence. Until that time, delays and other costly effects of the problem will inhibit economic development, affect output in some industries (steel, for example), and indirectly accentuate inflationary pressures. The military program is unlikely to be affected, however, because of its high priority.

C. Inflation -- After decades of minimal price increases, Iran has in the last few years experienced levels of inflation approximating 25%. Strong effective demand, brought on by accelerated government and private spending, has pushed up prices of domestic goods and services. High-cost industrial and consumer imports also have contributed to recent price pressures. Efforts to dampen inflation through subsidies and efforts to promote saving are not likely to have

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much influence. The government itself has not yet shown any serious disposition to restrain spending. A slowdown in the ambitious development plan would be a step in the right direction. Even more important would be government enforcement of the recently announced income tax hike on both industry and individuals in high income brackets. However, serious efforts to collect income taxes run counter to tradition and entail political risks in a country where few firms even bother to keep tax records. As one commentator pointed out, "Taxes are to be collected, not to be paid." Accordingly, we see little chance of measures taking hold to curb the inflation underway in Iran.

VI. Financial Future

Despite Tehran's prediction that capital will need to be imported by 1976, we believe that Iran's earning capacity will assure balance of payments surpluses over the next several years. This year, we forecast a current account surplus of about \$10 billion and, after allowing for an outflow of possibly \$4 billion in aid and lending, an overall balance of payments surplus of \$6 billion. Added to current reserves, Iran will have total foreign reserves of about \$15 billion at the end of the year.

Beyond 1975, we believe that earnings from oil (even with no price increases after this year) will rise by an average of over \$1 billion annually to some \$25.3 billion

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in 1979 and provide for surpluses on current account throughout the period. (See table 2) Imports during this period are adjusted to include estimated military purchases averaging \$5 billion annually. Expanded capital outlays during the period, however, will probably turn Iran's balance of payments surplus into a deficit by the end of the decade. The need to import capital could be delayed by oil price increases and expanded oil output or could be advanced by failure to create additional non-oil exports.

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Table 1

Iran: GNP, Budget, and Defense Outlays

Billions of Iranian Rials, Current Prices

Years (Beginning 21 March)	1967	1968	1969	1970	1971	1972	1973	1974	1975 a/
Gross national product	556.5	629.2	704.2	798.2	979.1	1,168.0	1,745.3	2,932.1	4,104.9
Budget expenditure b/	136.1	168.7	197.2	197.2	291.8	356.5	478.1	1,228.7	1,530.8
Current	82.1	98.8	114.4	114.4	176.7	211.1	316.9	800.7	1,015.1
Development	54.0	69.9	82.8	82.8	115.1	145.4	161.2	428.0	515.7
Defense expenditure c/	38.1	46.8	58.2	68.9	88.6	134.4	204.0	438.8 a/	627.8
Defense as % GNP	6.8	7.4	8.2	8.6	9.0	11.5	11.6	14.9	15.2
Defense as % total budget	27.9	27.7	29.5	34.9	30.3	37.6	42.6	35.7	41.0
Defense as % development expenditure	70.5	66.9	70.2	83.2	76.9	92.4	126.5	102.5	121.7

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TABLE 2  
CURRENT ACCOUNT  
(Billion U.S. \$)

	IRAN						
	1974	1975	1976	1977	1978	1979	1980
EXPORTS (F.O.B.)	22.0	21.9	24.3	25.9	27.5	28.5	27.5
OIL	21.3	20.7	22.7	23.9	25.0	25.3	23.6
NON-OIL	0.7	1.2	1.6	2.0	2.5	3.1	3.9
IMPORTS* (F.O.B.)	-7.2	-10.7	-13.5	-16.6	-20.3	-24.7	-30.1
TRADE BALANCE	14.8	11.2	10.8	9.2	7.3	3.8	-2.2
NET SER. + PVT. TRANS.	-1.4	-1.4	-1.6	-1.6	-2.0	-2.7	-4.2
FREIGHT AND INSURANCE	-0.9	-1.3	-1.6	-2.0	-2.4	-3.0	-3.6
INVESTMENT INCOME REC'TS	0.4	1.1	1.8	2.5	2.9	3.2	2.9
OTHER	-1.0	-1.3	-1.8	-2.1	-2.5	-2.9	-3.6
GRANT-TYPE ASSISTANCE	-0.4	0.0	-0.3	-0.2	-0.2	-0.2	-0.2
CURRENT ACCOUNT BALANCE	13.0	9.8	8.9	7.4	5.1	0.8	-7.6

\* Includes Military

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APPENDIX

Iran's Transportation Difficulties --  
Current Situation and Outlook

I. A Foreward on the Transportation System

Although large in comparison with other Middle East countries, the Iranian transportation system is inadequate for the size and growth needs of this rapidly developing country. The system comprises: 43,400 km of roads, 5,300 km of railways, 24 airports, 4 major oil ports, and 6 major general cargo ports. It is, however, concentrated along a few routes essentially linking the trade routes in the southern ports and the trade centers in the northwest and northeast with the capital of Tehran. Vast sections within the country now undergoing rapid development are inadequately served and the major centers are suffering from growth imposed bottlenecks in the system.

In terms of non-oil trade, Iran's ports are the most important component of the transportation system accounting for probably three-quarters of foreign

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commerce. Road and rail links with the northern countries of Turkey and the USSR account for most of the remaining foreign trade. Inland freight moves largely by road (62%) and rail (12%) and only to a small extent by air; the remainder consisting of petroleum moves by pipeline.

Although needs for centralized planning for transportation have existed for sometime, the direction and effort given this important sector have been lacking. At this juncture, Iran lacks a central Ministry of Transportation.

#### II. Current Congestion

In recent periods, Iran's increasingly large imports have strained the existing transportation system, resulting in serious bottlenecks. The ports of Khorramshahr and Bandar Shahpour, which handle roughly 80% of Iran's seaborne imports, are backlogged with incoming traffic forcing, in turn, increasingly long delays in unloading. The delays in early January 1974 of about 10 days had doubled by January 1975 and in early February 1975 were approximately one month. Some 100 ships on the average probably are on the waiting list to unload what would equate to about 18 days of total imports, based on last year's level. Iran's rail center on the Soviet

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border of Julfa also is backlogged with incoming and outgoing freight. Warehouses at many of the ports and rail entries are believed to be overfilled, resulting in open storage of goods. Associated with the above problems are shortages of equipment -- trucks, rail cars, etc. -- and personnel to operate equipment.

### III. Ability to Overcome Problems

a. Through Increased Efficiency -- A number of reforms were already introduced before the current port congestion, though there is still room for further efficiencies in port management and administration. The accustomed practice of customers to use the ports as storage areas could be wittled down considerably by increased storage charges. Systemized and more mechanized unloading procedures could probably also relieve some of the congestion. Along with these measures, increased training and importation of skilled handlers and shippers would help alleviate the situation. While some of the above measures could be introduced in short order, training and mechanization probably would be effective only over time.

b. Through Expanded Facilities -- Iran has embarked on a crash program to expand and improve its port, rail,

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and road system and has supplemented this effort with massive imports of foreign vehicles and drivers. While the infusion of imported vehicles and workers will provide some near term relief, the basic problem of port expansion, road building, and rail electrification will take time. Thus, for example, construction underway in late 1974 of 24 piers in the port of Bandar Shahpur will not be completed for another three years. At the same port, 14 new jetties to increase port capacity by 15 million tons per year are not expected to be completed before 1980. Iran's expanding military program superimposes a burden on efforts to accommodate the industrial civilian transportation needs. Military development along the southern portions of Iran's coast undoubtedly weighs heavily in the port congestion now taking place at such ports as Bandar Abbas. Construction of a new commercial port at Bandar Abbas, now in the planning stage, will not be completed for five years at which time the existing port will be turned over to the Iranian Navy.

IV. Outlook for the Transportation System and Resultant Import-Related Development in Iran

We do not see any solution to the transportation problems now confronting Iran within the next several years. As pointed out in earlier sections of this paper, many of the measures for expanding port facilities are not likely

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to reach fruition before 1980 at the earliest, while the massive port development program extends some ten years beyond, to 1990. At best, we see the "crash" programs for importation and development of road, rail, and ports yielding minimal relief -- recognizing, of course, that these efforts in turn call for increased importation of equipment. In the longer run, Iran should have a well balanced, highly developed transportation system.

In the light of the above, we see import-related problems for the Iranian development program. While the military development effort probably will not suffer, we believe that delays and shortages of industrial and consumer goods will forestall expansion, cause periodic interruptions in output, and generally contribute to a still troublesome inflation.

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